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IMPACTS OF CUSTOMS UNION WITH THE EUROPEAN UNION TO THE TURKISH ECONOMY

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─Abstract ─

The commencement of official relations between the European Union (EU) and Turkey dates back to 1959ş when Turkey applied for association followng the establishment of the European Economic Community (EEC). The EEC Council of Ministers accepted the application, and the following the negotiations the Ankara Agreement estbalishing an association was signed in 1963. Having viewed the historical period, making a turbulent progressş Turkey-EU relations has started to evolve into a very different dimension with the sign of Customs Union (CU). Through the CU, Turkey and EU have removed all barriers in front of trade excluding agriculture areas and service. This study aims to assess impacts of CU on Turkish economy. The study analyses four distinct impacts that are foreign direct invetsment, employment, growth and foreign trade.

Key Words: Customs Union, Turkish Economy, European Union

JEL Classification: F4, F15

1. INTRODUCTION

The Customs Union, which entered into force on January 1, 1996, constitutes the most important step for the modernization of the Turkish economy and its integration into world trade system. The CU is the most important development affecting the Turkish economy as a whole since the liberalization measures launched in 1980 (Balkir, 1998). Simultaneously, it becomes a cornerstone in Turkey's relationship with the European Community (EC) which dates back to the 1960s. The framework of the CU was drawn with the Ankara Agreement of 1963 and details were laid down by the Additional Protocol, which entered into force in 1973[1].

With the Decision No. 1/95 of the Turkey-EC Association Council, Turkey completed the transitional phase in its integration with the EC as foreseen in the Ankara Agreement and Additional Protocols and the final phase in Turkey-EU relations entered into force. During the transitory stage of 22 years, in which essential measures were put into force towards trade

[1] For the text of the Ankara Agreement, see Official Journal of the EC, 29 December 1964. For the text of the Additional Protocol, see Official Journal of the EC, December 1977.

liberalization and greater reliance on market forces, parties decided that conditions had been fulfilled for the establishment of the CU.

The Customs Union extends only industrial products and processed agricultural products. Traditional agricultural goods are excluded from the CU. The CU presents a unique example in the sense that Turkey is the first and only country that enters into such integration without being a member of the Union.

Another unusual feature of the CU is that it has gone well beyond the classical definition of a customs union, as a step identified by the prevailing integration theory[2]. To be clear in meaning, the CU between Turkey and the EU not only involves the abolition of all customs duties and charges, prohibition of all quantitative restrictions between parties and implementation of a common customs tariff to the outside world: it also makes necessary to harmonise Turkish commercial and competition policies, including intellectual property laws, with those of the Union, and extends most of the EU's trade and competition rules to the Turkish economy (Kılıc, 2005).

The CU has also served the culmination of the Turkey's liberalization efforts to catch up with the world economy, a process that came into existence in early 1980s, since EU rules have great parallelisms with those of the World Trade Organisation (WTO) and some other international regimes (Dervis, 2004).

In this wider context of the CU, Turkey has already adopted a great amount of relavant Community legislation, established institutions, and taken necessary measurement to implement them properly.

Turkey and the EU have dissimilar approaches in defining the CU. Turkey concentrated on the economic aspects. According to the provisions of the Ankara Agreement, the CU is the final stage of the transitional phase during which both parties fulfill their reciprocal obligations. Thus for Turkey, it was the first step of an irreversible chain of events leading to full membership, as according to the Ankara Agreement under Article 28, Turkey has the right to ask for membership after the successful completion of the customs union, although there is no automatic accession. Thus, Turkey never saw the CU as an end in itself. Indeed, given the fact that Turkey does not participate in the decision-making mechanisms of the Community concerning external economic relations regarding the third countries, it would have been admissible for Turkey to regard the CU as an end in itself. According to Turkish point of view, launching of the CU marked the end of the second phase of the path leading to the EU membership as foreseen by both the Ankara Agreement and the Additional Protocol, thus starting the third and the last phase of the process.

On the other hand, the European side assessed the CU as a way of developing close relations with Turkey and consistently refrained from making any reference to a link between the CU and the issue of membership. The CU looked like a skillful way to keep Turkey in the periphery of Europe (Balkir, 1998). It was even argued that the CU was part of 'the EU's containment policy for

[2] http://www.ikv.org.tr/en/gumrukbirligi.php (24.06.2009)

Turkey which was designed to strengthen EU-Turkey relations, while postponing the possibility of actual membership into the foreseeable future' (Arikan, 2003:82).

2. THE DEBATE CONCERNING THE CU

Since 1996, the debate about the CU in Turkey has been basically between defenders who think the CU will yield positive results in the long term, and the opponents, who discuss that it will harm national economic interest. However, irrespective of the political stance, it is generally accepted that the timing was not the best for Turkey as far as the economic conditions were concerned (Balkir, 1998).

Especially in big business circles, it was argued that the CU would bring many advantages to Turkey. Among the economic advantages for Turkey would be:

- The chance of Turkish producers to access to the group of countries which are among the richest countires on the continent and the world;
- Access to a market that has a huge trade potential and is among the most consistent markets in the world;
- The CU will crown Turkey's process of integration with the world economy. It will help rationalize and modernize Turkey's economic structure. Increased competition will improve the efficiency of Turkish firms;
- Through increased competition, Turkish consumers will have the chance to reach high quality products that would be possibly cheaper;
- Turkish consumers' consciousness would increase by the help of a competitive market area;
- Financial cooperation will contribute to Turkey's economic restructuring efforts and to the improvement of her infrastructure. It will also bring up the possibility of increased and more effective cooperation between EU and Turkish firms through joint Community programs;
- All of these will, in the medium and long term, would increase employment in Turkey, which will ease social tensions and improve the country's socio-economic situation.

On the other hand, the opponents believe that the CU has been signed at the expense of Turkey's "economic independence", and she accepted to be a periphery country "voluntarily". Their arguments can be summarized as below:

- Tariff dismantling beyond a critical point will eliminate domestic producers;
- Agriculture is excluded from the EU with the prospect of the free movement of the agriculture goods to be realized after Turkey's adoption of EU's Common Agricultural Policy (CAP). From the beginning, the Community granted tariff concessions on agricultural imports and tried to protect its agricultural sector by the sophisticated non-tariff barriers of the CAP;

- The CU has been incomplete also with regard to services. The liberalization of trade in services is expected to have more effect on the economy than the liberalization of goods, as the share of services in the economy has risen up to 60%;
- For Turkey, the CU would mean application of all preferential trade agreements concluded by the EU with third countries, and adaptian of trade agreements to the respective EC positions, which meant granting trade preferences to a number of countries that are competitors of Turkey in the Community market;
- Turkey has been the first country concluding a customs union without being a full member. As the support mechanisms were not designed in line with this approach, the CU was established without the adequate financial support mechanisms and also without being part of the decision-making process.

3. THE IMPLICATIONS OF THE CU FOR THE TURKISH ECONOMY

3.1 The Impact on Foreign Direct Investment (FDI)

Trade and investment have been the two key factors in Turkey's relations with the EU. Based on the previous enlargement experiences, it was expected that the CU would trigger substantial FDI by European companies. However, until recently, contrary to expectations, not only total FDI remained modest but also Turkey's share in the EU's FDI outflows remained inconsiderable.

Before 2005, the average annual inflows of foreign direct investment Turkey received was less than one billion dollars. Furthermore, the majority of the multinational corporations establishing subsidiaries in Turkey mostly targeted the country's sizeable domestic market, rather than using their subsidiaries in Turkey as an export base.

Turkey's failure to attract large foreign investment inflows was mainly owing to economic and political uncertainties surrounding the country in the 1990s and early 2000s[3]. During this period Turkey experienced two major economic crises in 1994 and 2001 during which GDP declined by more than 5% each time. Additionally, due to domestic political uncertainty and populist economic policies of successive governments, Turkey became quite vulnerable to external shocks such as the Russian crisis of 1998 and the Marmara earthquake that had shaken the industrial heartland of the country with substantial human losses.

However, after facing the threat of a complete systemic breakdown in 2001, the successful implementation of structural reforms[4] and the election of a single-party government in the November 2002 general election lessened both economic and political uncertainties. Apart from the macroeconomic and political uncertainties, international analysts attribute the low level of FDI in Turkey to institutional, legal and judicial obstacles (Dutz, Us and Yılmaz, 2005).

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[3] For a more detailed account of the pre-2005 investment climate in Turkey (see Dutz, Us and Yılmaz, 2005)
[4] These reforms, dictated by IMF, targeted the conduct of fiscal policy and the regulation of financial sector.

Although CU was not a big impulse, the EU's December 17, 2004 decision to begin membership negotiations with Turkey marked the turning point in FDI flows to Turkey. The EU decision produced favorable conditions to convince international investors that the future of Turkey lies with the EU (Sayek, 2007). The EU's strong signal about the prospective EU accession of Turkey convinced the investors that the most problematic institutional, legal and judicial obstacles tı FDI inflows would be eventually dismissed.

As a result the FDI inflows to Turkey bounced. While FDI inflows amounted to less than $1 bn before 2004 (repetition) and reached only $2.5 bn in 2004, it reached a record level of $9.6 bn in 2005[5]. FDI inflows continued to increase to $20 and $22 bn in 2006 and 2007, respectively[6]. Despite the global financial crisis, in 2008 FDI inflows amounted to $18 bn (YASED, 2009).

In 2008, $14.7 bn of the total inward FDI flow amount of $18 bn to Turkey represents net foreign capital inflows, and $2.9 bn of it represents the real estate purchases of foreigners (YASED, 2009). As 66% of FDI inflows were directed to the services sector, industrial sectors received a share of 34% form these inflows. It is noticeable where inflows to industrial sectors remained almost unchanged, inflows to services sectors dropped by 30%.

An overall look at the FDI inflow figures of 2004-2008 reveals that 78% of the inflows have been directed to the services sector[7] and that the main branches of the industrial sector, which benefits from 22% of the total inflows, are; food-beverages-tobacco, textiles, chemicals, machinery and equipment, non-metallic minerals, basic and fabricated metals, motor vehicles and electrical and optical instruments (YASED, 2009).

When we analyse the origin of FDI inflows figures of the last five years indicates that 76% of these inflows come from European countries, 10% originate from North America, and 9% from Gulf States. The leader among European coutries is the Netherlands with a 22% share of last 5 years' inflows.

3.2 The Impact on Growth

In the medium and long term, the CU is expected to increase competitiveness and productivity thus contributing to the overall economic growth. When the CU was launched in 1996, Turkey's economic growth rate was 7.1%. Although Turkey saw a higher growth rate (8.3%) in the next year, it dropped to 3.9% in 1998, a dramatic decrease in 1999 with -6.1% due to the economic depression of the earthquake. Thre recovery in the next year with 6.3% was interrupted by the

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[5] Turkey was not only country that experienced such a sharp rise in FDI inflows with the initiation of the EU membership negotiations. Central and Eastern European countries also experienced significant increase in the FDI as soon as the membership negotiations started.
[6] In 2006, Turkey had ranked 17th among world's top 20 FDI destinations, but then had dropped to 23rd position in 2007. Correspondingly, as it had ranked in the 5th place among developing countries in 2006, it had stepped down to 9th position in 2007 in this category.

[7] This highlights the significance of service sectors in the Turkish economy, and the disadvantage on the Turkish side due to the exclusion of services under the CU agreement.

crisis of 2001 to -9.1%. However, Turkey grew an annual average of 7.2% between 2002 and 2006. In 2007, GDP growth slowed down to 4.6% and GDP grew by 4.2% in the next year.

These fluctuations in the Turkish economy were strongly connected with macroeconomic and political uncertainties and global financial crises rather than to the impact of the CU. As indicated earlier, since 2001, much progress has been taken place in stabilizing the economy addressing the fundamental causes of these crises. This is especially noticeable in the resumed growth path and reduced inflation rate. In the 2005 Regular Report, Turkey is already considered as a functioning market economy as long as it resolutely maintains its recent stabilization and reform achievements (Commission of the European Communities, 2005). Furthermore, Turkey did meet the Maastricht criterias of the budget deficit-to-GDP and the public debt-to-GDP by the end of 2007.

3.3 The Impact on Employment

Turkey's growth rate in the economy has not yet produced a net increase in jobs to offset the number of young workers[8] entering into the labor force or existing workers coming out of sectors like agriculture. Additionally, the CU did not contribute to the solution of this problem through the use of low labour cost to attract foreign direct investment. There has not been an essential increase in the employment rate after 1996, which is still around 43% in 2007-2008. In particular, the female employment rate remained low at less than 24% of the total working-age population. The unemployment rate remains between 10% and 11%. Unemployment was much higher among the young (about 20%). Long-term unemployed accounted for more than half of job-seekers. Agriculture typically employs many unpaid family workers. This leads to a statistically lower rate of unemployment, but suggests large pockets of underemployment in this sector and the economy at large.

The target employment rate for Europe has been set at 70% by 2010. To meet this same target with a still growing population, Turkey would have to generate about 14 million jobs. Of course that is not realistic in the labor market conditions of today in Turkey as under current trends of employment growth, only about 1.5 million net jobs would be created by 2010 (World Bank, 2006). The Labor Market Study suggests that Turkey can create more jobs in the short term as well as over the next ten years only if reforms are perofmed in four broad areas: the investment climate, financial markets, labor markets, and what we might call the knowledge economy, including education reform and skills enhancement (World Bank, 2006).

3.4 The Impact on Foreign Trade

[8] Turkey's growth potential lies in its growing population of working age, that shows some remarkable features which distinguish it from the most EU members. The best-known difference is that Turkey's population is still growing, whereas the population in Europe has been either stagnating or growing rather slowly over the last three decades. For the next generation, Turkey's population growth will stil remain more dynamic compared to other EU-27 member countries. But, a growing population provides economic opportunity only if employment increases as well.

Even in 1963 at the beginning of the association, the Community has always been the main trading partner for Turkey. Turkey's principal trading partner has been Germany in the EEC. The other important trading partners are Italy, France, the UK and Holland. In 1963, exports to the EC represented 38% of Turkey's total exports, and imports from the Community represented 28.5% of total imports.

Nearly 13 years after the Customs Union, EU has a stable share of around 50% in Turkey's foreign trade. The CU is important for Turkey's production structure, since 85% of total imports are intermediary and investment goods. The biggest increase in imports from the EU is in consumer products. The share of consumer goods rose to 15.1% in 2007 from 7.3% in 1994, while the share of intermediate goods has remained almost constant at around 63% and the share of investment goods decreased to 21.4% from 29.3% in the same period.

The share of investment goods in total exports from Turkey to the EU rose to 14% in 2007 from 2.9% in 1994, and the share of intermediate goods rose from 32.5% to 38.7%, while the share of consumer goods declined to 47.1% from 64.6% in the same period.

The numbers show the changes in the structure of Turkey's foreign trade after the CU. However, Customs Union has also been a strong proof of the capacity of Turkey to cope with competitive pressures and market forces within the European Union. It has also increased Turkey's resilience against global turmoil. The East Asian and Russian crisis of the 1990s and the global recession that has started in 2008 would have affected Turkey much more in the absence of CU.

Turkish economy's performance after joining the CU provides insights for its future performance as it intensifies Turkey's integration with the EU and the rest of the world. Traditionally, as indicated earlier, Turkey has had strong trade relations with Europe. Between 1999 and 2003, trade with the EU-25 accounted for 53% of Turkey's exports and 51% of imports. Defining Europe to include countries that became members in 2004, and Bulgaria and Romania that joined in 2007, Europe's share of Turkish exports and imports in 2004 was 59% and 53%, respectively. With 49% share in imports at the end of 2005, EU continued to be the most important trade partner for Turkey, despite the rapid increase in imports from China in the 2000s. The Chinese share in imports rose to 7.8% in 2007 from 2.2% in 2001.

As a result of the Customs Union, there was a small decline in import tax revenues as Turkey lowered tariffs for imports from the EU. According to calculations reported in Togan (1997), the unweighted average tariff for the manufacturing industry decreased from 13.5 percent in 1995 to 3.6 percent in 1996. Import tariff revenues fell from 2.8% of total tax revenues in 1995 to an average of 1.1% over the period 2001–05. The decline in tax revenues, however, is too small to be blamed for the large budget deficits.

Increased competition in the form of higher imports from the EU forced productivity improvements in the manufacturing industry. Before the CU came into force some sectors such as automotive, durable home appliances, electrical machinery, and equipment had continued to receive protection behind high tariff barriers despite the import liberalization process that started a decade ago. Despite this fact, productivity growth was higher in import-competing sectors compared to export-oriented and non-traded goods sectors (Ozler and Yilmaz, 2009).

The track record of the Turkish manufacturing industry in response to the CU has been better than expected, especially when one considers that Turkey received very little financial support from the EU to help ease the adjustment burden. As shown by Taymaz and Yılmaz (2007), even though the total factor productivity in the manufacturing industry did not increase much between 1996 and 2000, the productivity in those sectors that experienced significant increases in import penetration rates rose substantially.

Aysan and Hacıhasanoglu (2007) incorporated the change in the technological composition of manufacturing exports by analyzing percentage increase in sectoral export volumes. They concluded that "Turkish exports experienced a structural change and shifted from conventional and unskilled labor intensive sectors to technology intensive sectors that required more skilled labor" (p. 191).

Kaminski and Ng (2007) have adopted a taxonomy developed by Landsman and Stehrer (2003) to assess the technological content of Turkish exports in three categories. They found that EU oriented exports show a dramatic shift towards medium and high technology products, although low technology and unskilled labor-intensive products remain as major areas of specialization. According to these authors that shift has also led to higher wages in higher technology sectors, which in turn led to higher wages in services and unskilled labor-intensive sectors with obvious implications for their international competitiveness.

The CU agreement with the EU did not have much impact on Turkish exports in the first five years. The compounded annual growth rate of exports between 1996 and 2001 was 6.2% compared to to 14.3% growth rate between 1980 and 1995. The EU had already removed tariffs on imports from Turkey long before the CU went into effect. In addition, despite the CU, the EU continued to reserve the right to impose antidumping duties on Turkish exports to the EU as well as keeping technical (regulation) barriers. Coupled with the appreciation of the lira, it is therefore not surprising that Turkish exports did not surge to the EU countries immediately after the CU.

The impact of the CU on Turkish exports was realized with a long delay, only after the 2001 crisis. The depreciation of the Turkish Lira and the contraction in domestic demand that followed the economic crisis of February 2001 forced domestic producers to search for export markets. Export revenues increased by only 12.6% in 2001. Exports continued to grow even after the domestic market resumed growth in 2002 and 2003 at a rate higher than the period prior to the crisis. Exports grew by 15% in 2002, 31 and 34 percent in 2003 and 2004, respectively and by 16% in 2005 and 2006. Better-than-expected export performance in 2002 and 2003 was achieved despite a 25% real appreciation, and even nominal appreciation, of the Turkish lira during this period. This remarkable export performance is in part due to the newly acquired competitiveness of the Turkish manufacturing industries that was forced by the increased competition after Turkey joined the CU.

4. CONCLUSION

Since the 1960s, EU trade with third party countries has died down and the level of intra-EU trade has increased, as a result of trade diversion within the EU and the lifting of intra-EU trade barriers. In light of this, it could be argued that the EU may become a self-sufficient entity, having a high level of trade protectionism. This would not be desirable for those countries in the European region that are heavily dependent on EU markets and those seeking to improve trade volume with the EU, such as Turkey. However, despite the similar product profiles of EU members Greece and Portugal, EU trade with Turkey has increased since the 1980s, following an opposite trend to the overall level of extra-EU trade in total EU trade. In view of this, Turkey may be considered an important market for the EU, not so much in terms of trade volume, but as useful trade partner.

Turkey is the first country to conclude a customs union with the EC without being a full member. However, since the aid and the support mechanisms in the Community are designed in line with the full membership perspective, Turkey received very little financial support. Nevertheless, the impacts of the CU on Turkish economy should not be considered negative, but far from fulfilling the expectations. It is beyond discussion that some main features of this relationship are not to the advantage of Turkey and gave rise to frustration on the Turkish side, strengthening the euro skeptic trends in Turkey. Given the share of agriculture in trade and the share of service sector in the Turkish economy, the exclusion of both sectors from the CU has become a major shortcoming to Turkey, a point not seen ahead at the time when the Association Agreement was drawn but became apparent in the second half of the 90s. The CU stipulated in the Ankara Agreement and the Additional Protocol was limited to abolishing customs duties and taxes having equivalent effects and imposing common customs tariffs on third countries. However, in parallel to the evolution of the acquis communautaire and the changes in the global perspective, such as the Generalized System of Preferences, and other preferential trade agreements concluded by the EU, the concept of customs union underwent vital changes and enlarged. Thus, it became of utmost importance to emphasize the fact that the CU between Turkey and the EU is not a kind of relationship in itself, but should be regarded rather as an integral part of a gradual process of integration, the origin that goes back to the initial phases of the relationship between the partners. Therefore, it is only by means of total integration that such a relationship could be sustainable in the long term.

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